Taxation of Virtual Digital Assets - A Primer

Oct 31, 2022

Sandip Mukherjee
Director, International Tax, Fox Mandal & Associates

Need for recognizing and taxing Income from VDAs:

The world has witnessed massive growth in demand for and transactions in cryptocurrencies, non-fungible tokens (NFTs) and other digital assets. These digital assets have attracted several investors around the globe. This outlook of investors in digital assets have led to an increased demand and trade of digital assets, thereby resulting into exponential value appreciation and in turn the value of digital assets.

Specifically, when we talk about the cryptocurrencies, there are several thousands of cryptocurrencies in circulation; *inter alia*, Bitcoin and Ethereum being the top 2 cryptocurrencies in terms of market share. Presently, the global crypto market is of USD 1.06 trillion. Likewise, according to the report of 'Market Decipher', the global market size of NFT itself is estimated to be at USD 232 Million, as in the year 2020 and subsequently, is expected to grow 3 times of its current size by the year 2031. According to certain reports, India tops the chart of countries with most cryptocurrency holders in the world, with cryptocurrency investment of approximately USD 6.6 billion, as of May 2021.

Many countries have denied recognizing cryptocurrencies as legal tender and have either banned them or have imposed strict regulations against their usage and acceptability. However, interestingly, a country like El-Salvador has recognized "Bitcoin" as their legal tender. Further several countries have recognized cryptocurrencies and other digital investments as assets.

Accordingly, due to Indian population's huge investment in cryptocurrency, NFTs and other digital assets as well, the Government of India (GOI), in its Finance Act 2022, recognized and introduced taxation of a new class of asset under The Income Tax Act, 1961 (hereinafter referred as **"the Act"**), 1961, called as VDAs.

What does VDA Include?

The definition of VDA as given under section 2(47) of the Act, is an inclusive definition. However, the Central Government may, vide a notification, exclude any digital asset from the definition of VDA.

VDA as defined under the Act *inter alia*, includes:

A. Any cryptographically generated Information/Code/Number/token

- not being Indian or foreign,
- having an exchange value represented in digital form,
- exchanged with or without consideration,
- with the promise or representation of having inherent value; or
- functions as a store of value or a unit of account,
- that may be used in any financial transaction or investment,
- and can be transferred, stored, or traded electronically.

B. NFT or any other token of similar nature; or

C. Any other digital asset as may be notified by Central Government[1].

Digital asset excluded from the definition of VDA

The Central Government has excluded following digital assets from the definition of VDA through a notification[2]:

1. Gift card or vouchers that may be used to obtain goods or services or discounted goods or services;
2. Mileage points, reward points or loyalty cards without monetary consideration and that may be used only to obtain goods or services or discounted goods or services;
3. Subscription to website or platforms or application; or
4. Any NFT backed by an underlying tangible asset where transfer of such NFT results in legally enforceable transfer of ownership of such tangible asset.

How will the Income from VDA be taxed?

The Finance Act, 2022 has inserted **Section 115BBH** in the Act to bring VDA under tax.

As per the calculation of gain on transfer method given under Section 115BBH, there is a metaphoric representation of taxing of gains arising upon transfer of VDA similar to that on transfer of any other capital asset. However, the law has not restricted the nature of holding of VDA to a “Capital Asset” alone. Hence, any gain on transfer of VDA held as stock-in-trade or otherwise shall also be taxed as per the provisions of Section 115BBH.

Further, any VDA received against no or low consideration would be taxed in the hands of recipient as ‘’Income from Other Sources’’, as per the specific provisions of section 56(2)(x) of the Act.

Calculation of gains on transfer of VDA

For computation of gains on transfer/ sale of a VDA, the cost of acquisition of such asset must be deducted from its sale price.

Particulars	**Amount**
Full value of consideration	XXX
Less: Cost of Acquisition	(XXX)
Taxable gains on transfer of VDA	XXX

Deductions available in computation of gains from VDA

The law does not allow any other form of deduction except the cost of acquisition of such VDA for computation of gains arising out of the transfer.[3]

Availability of Indexation benefit on transfer of VDA

The law has categorically denied any benefits of indexation or cost of improvement with respect to computation of gains on the sale/ transfer of VDA.

Allowability of Set-off of Loss on VDA

In a scenario of occurrence of loss on the transfer/ sale of virtual assets, such loss cannot be set off against:

1. Gain arising on the transfer of another VDA.
2. Income under any other head of income.

A simple example for the same would be as follows:

Person “A” sells VDA “X” and makes a profit of Rs.60,000 in one transaction and in another transaction incurs a loss of Rs.1,00,000 on sale of VDA “Y”.

In this case, he/she will be liable to pay tax on the profit made of Rs.60,000, but the loss that he/she has suffered, would not be set off against the profit made, even though the transactions may have been simultaneously done and falling under the same head of income.

Allowability of carry forward of losses on VDA

The loss arising on VDA cannot be carried forward. This development is interesting to note as all other asset classes have the benefit of setting off losses and carrying forward of those losses into the next year, making this particular asset class the least investment friendly.

Rate of Tax on gain on transfer of VDA

The gain on the transfer of VDA is to be taxed at a flat rate of 30%, plus cess and surcharge[4].

Applicability of Tax Deduction at Source (“TDS”) provisions in case of VDA

Section 194S was inserted vide Finance Act, 2022 for withholding of tax on transfer of VDA. The details are as follows:

When to deduct tax at source?

TDS must be deducted at earliest of:

1. making payment (by any mode); or
2. crediting of such sum to the account of the resident

Threshold for TDS

The person making payment would be liable to deduct tax under following circumstances:

Person making payment (Deductor)	**Consideration**
Individual or HUF, **not** having any Profit/Gain from business or profession	Exceeds Rs.50,000 in a FY
Individual or HUF: -having Income under head 'Profit/Gain from business or Profession' **and**; -turnover from business does not exceed Rs. 1 Crore **or**; -receipt from profession does not exceed Rs. 50 Lacs in the FY preceding the FY in which VDA is transferred	Exceeds Rs.50,000 in a FY
Other cases	Exceeds Rs.10,000 in a FY

Whether TDS applicable in case of recipient being Non-Resident?

TDS u/s 194S is to be deducted by any person making **payment to** a **resident person**. Hence, **no TDS** to be deducted u/s 194S **if** the **Recipient** is a **Non-Resident**. However, the provision of Section 195 would get attracted in such cases.

Rate of TDS

TDS must be done at the rate of 1% of the total consideration (excluding GST, if any).

Valuation of consideration for the purpose of deduction of tax on transfer of VDA

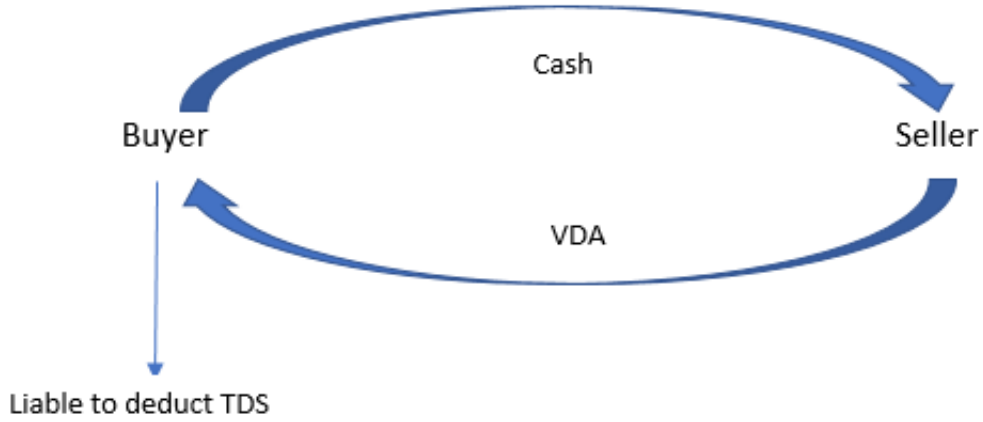
The transfer of VDA can take place either:

1. Through Exchange
2. Through Peer-to-Peer

Valuation of consideration under the following circumstances is discussed below:

A. Liability to deduct tax when the consideration is in Cash

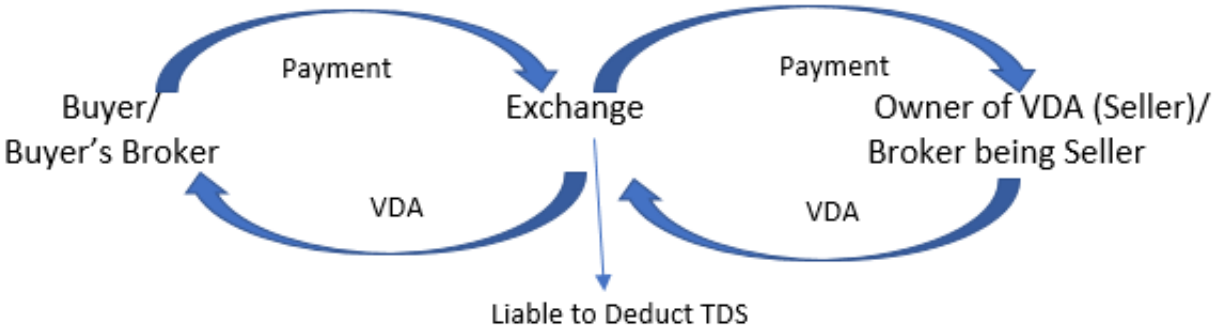
1) Transfer on Peer-to-Peer:



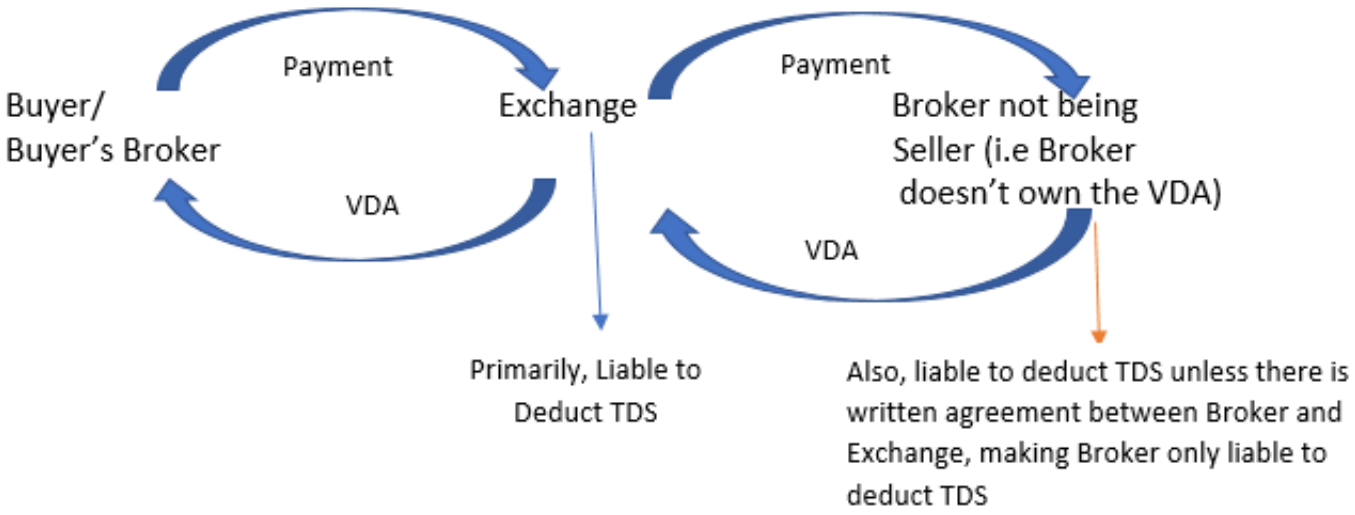
2) Transfer through Exchange:

Value of consideration will be Actual Amount Paid/Credited by buyer (deductor). Further, liability to deduct TDS when the consideration is in Cash under different scenarios, is discussed below:

a. Exchange making payment/crediting amount to seller/broker being the seller [i.e. broker is owner of the VDA]: Exchange is liable to deduct tax under section 194S.

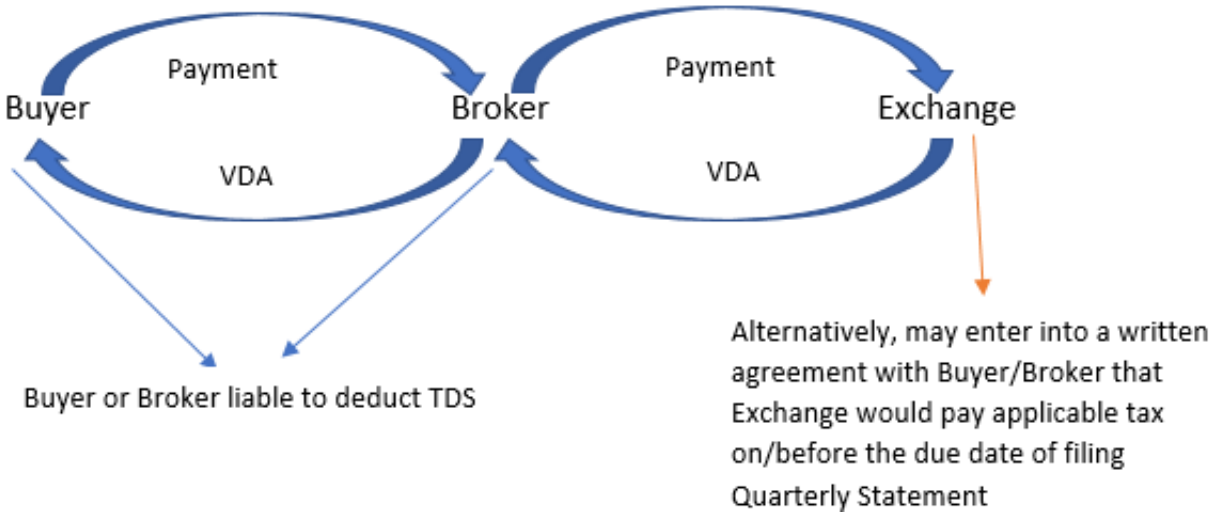


b. Exchange making payment/crediting amount, but broker involved in transfer is not the Seller: Both, the Exchange and the Broker will be liable to deduct TDS, unless there is a written agreement between Exchange and Broker, making only the Broker liable to deduct tax.



c. VDA owned by and transferred through Exchange

Primarily, Buyer/Broker being the person making payment would be liable to deduct TDS. However, upon a written agreement between Exchange and Buyer/Broker, the Exchange may itself deposit the amount of tax and file quarterly statement in Form 26QF



"Exchange" means any person that operates an application or platform for transferring of VDAs, which matches buy and sell trades and executes the same on its application or platform.

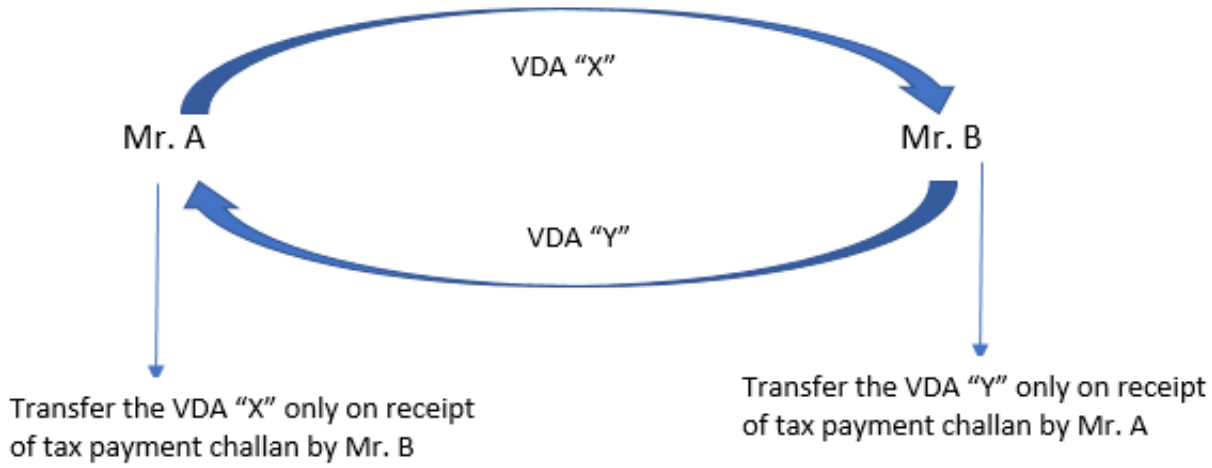
"Broker" means any person that operates an application or platform for transferring of VDAs and holds brokerage account/accounts with an Exchange for execution of such trades.

B. Liability to deduct tax when the consideration is in kind, wholly or partly, or in exchange of another VDA and cash is not sufficient to meet TDS liability

Person making payment should ensure that the required tax on such consideration is deposited, before releasing the consideration.

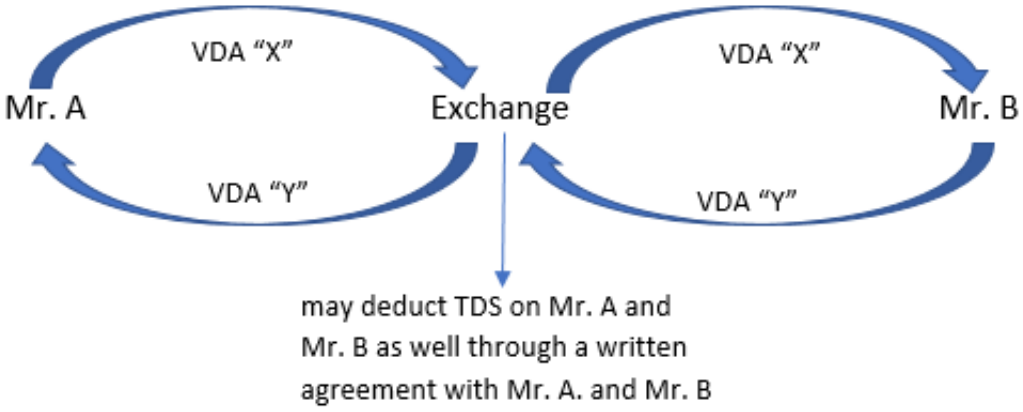
1) VDA against VDA under Peer-to-Peer:

Under Peer-to-Peer transaction of VDA against VDA, both the parties are buyer as well as seller, hence both parties are liable to ensure that the tax is deposited by another before release of consideration.



2) Transfer of VDA against another VDA through Exchange:

In case the transaction of transfer of one VDA against another VDA is through Exchange, for the sake of convenience, the Exchange may opt to deduct and pay the tax on the Buyer as well as the Seller. This can be done by the Exchange through an agreement with Seller/Buyer.



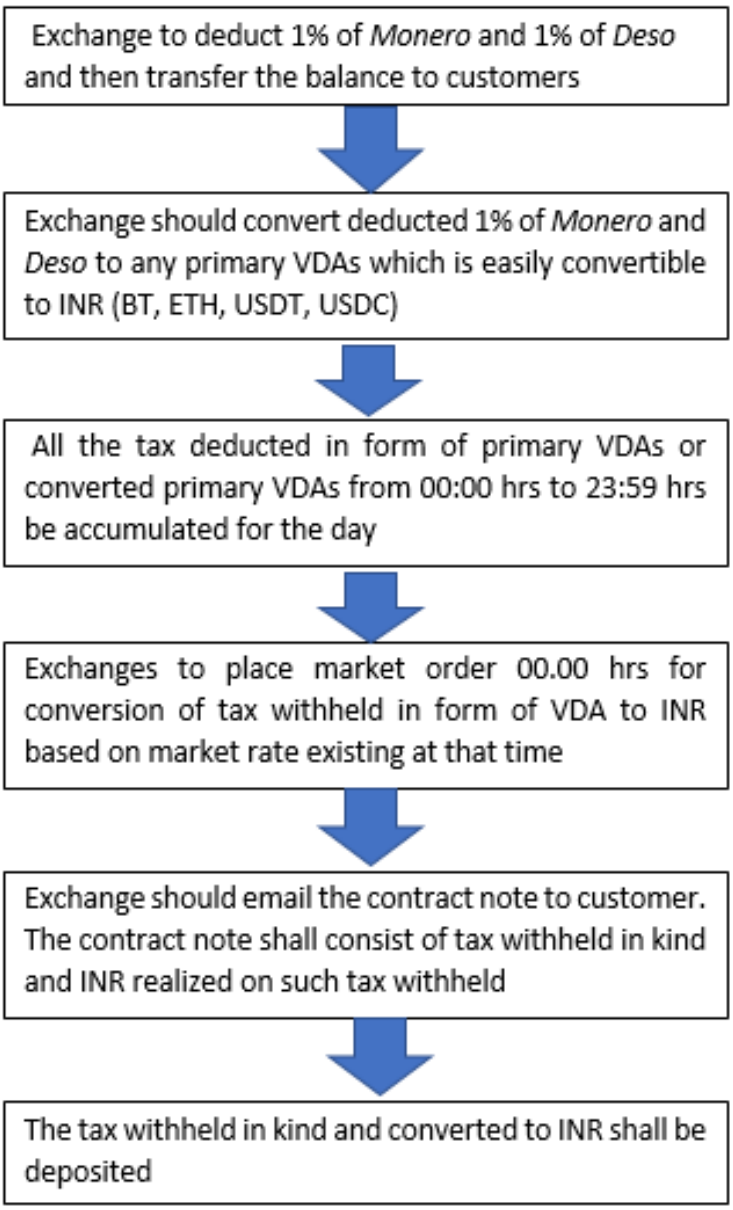
Valuation of TDS deducted in 'Kind' under transaction of VDA against VDA:

If the Exchange opts for tax deduction, the possibility of tax deduction in kind may arise and hence the need for its conversion to cash before deposit with Government may arise.

To this the CBDT has specified following mechanism:

Illustration:

VDA *Monero* is traded against the VDA Deso (both not being primary VDAs) through the Exchange. And the tax @ 1% of Monero and Deso is deducted by the Exchange in kind.



Special Case: Transaction where Payment is made through Payment gateway.

Payment gateway would NOT be required to deduct tax if person required to deduct tax (as discussed above) has deducted the tax. For implementation of this, payment gateway may take an undertaking from the person responsible to deduct tax in this regard.

Effective date of Section 194S: 01st July 2022

How the threshold limit of Rs. 50,000 or Rs. 10,000 is to be calculated?

1. CBDT has clarified[5] that the consideration threshold limit of Rs. 50,000/Rs. 10,000, is to be counted from 01 April 2022.

Hence, if the threshold limit of Rs.50,000/Rs.10,000 is exceeded by 30.06.2022, TDS is to be deducted on all the payments/credits made on/after 01.07.2022.

Summary Views:

The framing of tax law to curb tax leak on the gains arising from a VDA is a valiant step. The CBDT has vide introduction of the tax provisions on VDA and the subsequent notifications, tried to address the several issues on taxing of VDA transactions. However, the concept of trading in VDA is yet globally evolving and with passage of time certain practical difficulties are likely to arise, necessitating further clarifications and guidance by CBDT vis-à-vis taxation of VDAs. This would have to be done transparently, on a dynamic and pro-active basis.

Under the current laws, in situations where the buyer and the seller are both residents, are unknown to each other and are trading through an Exchange operating outside India, would require further analysis on who shall be liable to deduct the TDS. Forgoing this, how these transactions will be identified and who would be the reporting entity, would remain an important question that would need to be addressed.

---

[1] On 7th October 2022 RBI has announced that limited pilot launches of Central Bank Digital Currency [CBDC] or Digital Rupee (e₹) will begin soon

[2] Notification No. 74/2022/F. No. 370142/29/2022-TPL (Part-I)] dated 30th June 2022

[3] Cost of mining is not considered under “cost of acquisition”.

Mining: Validation of cryptocurrency's coins under Blockchain transaction

[4] Cess rate is 4% and Surcharge is as follows:

- For Individuals

Income range	Rs. 50 Lakhs to Rs. 1 Crore	Rs. 1 Crore to Rs. 2 Crores	Rs. 2 Crores to Rs. 5 Crores	Exceeding Rs. 5 crores
Rate	10%	15%	25%	37%

- For Domestic Company

Income range	Rs. 1 Crore to Rs. 10 Crores	Exceeding Rs. 10 crores
Rate	7%	12%

- For Foreign Company

Income range	Rs. 1 Crore to Rs. 10 Crores	Exceeding Rs. 10 crores
Rate	2%	5%

- For Partnership firm, LLP, Local Authority and Co-operative society @ 12% on Income exceeding Rs. 1 Crore.

[5] Circular No. 13 of 2022/F. No. 370142/29/2022-TPL (Part-I) dated 22-06-2022